4. Service Quality/Q Factor

The Act requires that an alternative regulation plan serve to maintain the quality and availability of telecommunications services. 210 ILCS 5/13-506.1 (b)(6~~) Under~~ Under the Plan the Commission concluded that the best way to eliminate AI's incentive to reduce service quality ~~will~~ would be to adopt a service quality component to the price cap formula which penalizes AI for not maintaining service quality. Under the Plan the Commission adopted eight separate quality of services measures. For each measure, AI receives a score of zero if it meets the benchmark, and a score of -.25 if it fails to meet a specific benchmark. Without the benefit of history, the Commission concluded that its Q component would provide considerable incentive for AI to meet its benchmarks. Order at 59.

Staff recommends that the Q factor be eliminated from the price cap index. Staff has recommended that the issue of service quality be addressed outside the price cap index ~~in separate proceedings~~ but in the alternative regulation plan. AI, City/GCI have alternative proposals as to how to handle the issue of service quality, but also prefer that service quality be addressed outside the index.

Commission Analysis and Conclusion

We agree with Staff and GCI/City and conclude that the issue of service quality be addressed within the alternative regulation plan but outside the scope of the price cap index itself. A detailed examination of the issue of service quality can be found in the Service Quality Section of this order.

C. Pricing Flexibility

AI's Position

AI recommends that the Plan be modified on a going forward basis to allow the Company greater flexibility to increase prices. According to AI, pricing flexibility would "allow it to 1) adjust rates to the more competitive marketplace, and 2) allow it to move toward a more "economically efficient rate structure." (Staff Reply Brief at 21, citing Ameritech Initial Brief at 6.) Under the Plan, AI's pricing flexibility is limited to 2% over the percent change in the PCI and a rate cap was imposed on basic residential services for five years. (Ameritech Initial Brief at 42, citing Order at 64-65, 70.) AI states that because of the severe limitation placed upon it, it has not been able to increase noncompetitive rates since the Plan went into effect.

In support of its argument for increased pricing flexibility AI argues that its residence network access lines are priced too low and being subsidized by other services. AI contends that reasonable per service rate increase be allowed to effectuate a smoother transition to competition and a more efficient rate structure. AI has alternative proposals relative to pricing flexibility. Should the Commission grant its request for rate re-balancing, then in that event AI requests the ability to increase individual rate by 5% annually over existing levels, while at the same time decreasing rates of other services to maintain compliance with the PCI. ~~(Ameritech Initial Brief at 42.)~~ AI asserts less upward pricing flexibility is needed if rate re-balancing is accepted. Should the Commission reject AI's rate re-balancing proposal, then AI requests authority to increase individual rates up to 10% per year with a cap of 30% during a 5-year period. AI asserts that Staff and City/GCI's objections to pricing flexibility are unprincipled. AI contends that Staff and City/GCI's view is shortsighted in that both fail to see the harm to ratepayers when AI's rates fail to cover their costs and are unsustainable in a competitive marketplace. Further, AI asserts that pricing flexibility allows for more gradual increases as opposed to sudden changes in prices resulting from proceedings such as rate re-balancing. ~~(Id at 43.)~~

AI further argues that the LRSIC costs associated with providing network access lines have increased, not decreased. Even if Staff and GCI have concerns about the validity of its cost studies, AI contends that none of the parties had attempted to assess where network access line prices need to be over the long run to facilitate economic efficiency and competition and that substantially higher levels of contribution should be expected from this service. AI acknowledges that reasonable people can differ over what degree of flexibility it should have under the Plan. Finally, the Company disputes GCI's claim that it would abuse the pricing freedom it was requesting, noting that the Commission approves the annual filing proposal each year after a proceeding.

Staff's Position

According to Staff, AI has failed to explain why it needs any significant level of pricing flexibility for services for which it has no competitors. Should either of AI's proposals be approved, Staff contends the upward pricing flexibility allows for AI to increase noncompetitive rates where no competitive pressure exists. This type of conduct, Staff asserts, is called "Ramsey pricing." Basically, Staff charges that AI pricing flexibility proposals are nothing more than a desire to charge customers more with no fear of losing customers to competitors. Staff concludes that the 2% pricing flexibility remains appropriate and should be implemented going forward.

GCI/City's Position

Likewise, City/GCI argue AI's pricing flexibility proposals be rejected. Like Staff, City/GCI contend that AI has offered no evidence that the two percent pricing flexibility has impeded AI ability to react to market forces. City/GCI further argue that no evidence was presented indicating AI lost market share as a result of the two percent limit upon pricing flexibility. Also, City/GCI argue that AI's proposals allow AI to modify rates without regard to cost.

Commission Analysis and Conclusion

The Commission concludes that the current 2% pricing flexibility afforded to AI be maintained on a going forward basis. Essentially, AI's difficulty with the current 2% upward pricing flexibility limit is that it has not been able to benefit from that limit. However, the rationale for increasing pricing flexibility is not supported by the record. There is little or no evidence indicating AI's non-competitive services have suffered market share loss or that it has been unable to react to market forces. ~~AI's argument relative to costs being at least at their long run service incremental cost s compelling and is addressed in the rate re-balancing section in this order. However, there~~ There has been however, no evidence or argument presented which persuades us to increase pricing flexibility~~ for services which have little or no competition~~.

D. Proposed New Component Merger Related Savings/M Factor

This Commission approved the merger of Ameritech Corporation and Southwestern Bell Corporation ("SBC"). (Merger Order Docket 98-0555). In the Merger Order the Commission ordered that AI track all merger related costs and savings. Pursuant to the Merger Order, information on merger related costs and savings are to be submitted annually with AI's annual price cap filings until an updated price cap formula is developed in 98-0252. In the Merger Order the Commission anticipated that an updated price cap formula could be developed in this proceeding that would permanently flow through 50% of net actual merger savings to customers. Further, the Merger Order required the retention of a third party auditor to develop and establish accounting standards so that the Commission could identify merger related costs and savings. In the ~~event there~~ event there are merger related savings, 50% of those saving allocable to AI are to be allocated to Illinois ratepayers.

AI's Position

AI's position is that a permanent solution to merger savings cannot be adopted yet. AI contends that the Merger Order requires that permanent rate adjustments be based on actual net merger savings, and since AI will not reach a "going level" of merger savings until the first 1/4 of 2003, it is premature to address the issue of merger savings. AI recommends that the amount of net merger related saving should be based upon the year 2002. However, since there was no consensus of the parties, AI suggests that merger saving continue to be handled in the annual price cap filing on an interim basis and that a permanent solution be deferred to another proceeding.

Staff's Position

In its "New Components" section of its Reply Brief, Staff states that it would prefer that merger savings be handled through a one time permanent adjustment to the PCI but then states that the Commission could also calculate a "M" factor based upon merger savings as well. In the Merger Costs and Savings section of its Reply Brief, Staff again suggests that the Commission may consider two options, either make a one time adjustment to the PCI, presumably whenever a final determination of merger related savings can be obtained, or include a merger related savings factor to the price cap formula. With respect to AI's proposal that any permanent solution be based upon year 2002 data, Staff disagrees. Staff argues that AI's proposal will not capture all merger related costs and savings because by 2002 only 96% or merger related savings ~~will~~ would be actualized. ~~(Staff Reply Brief at 33.)~~ Staff recommends that the terms of the merger condition remain in effect until the Commission completes its review of this modification to the Plan. Staff suggests that this modified plan be reviewed in four years, with a final order in place before July 1st of the fifth year. ~~(Staff Reply Brief at 32.)~~ By 2005, Staff contends, the extent of actual merger related savings will be known and that a one-time adjustment to the price cap index could then be made.

~~Staff's Position~~

Alternatively, Staff proposes that the price cap formula be modified at this time to reflect 50% of SBC's current estimate of merger costs and savings. Staff opines that since merger costs and saving amounts have already been reviewed by SBC's upper management and analyzed by its merger integration teams, the current estimate of net merger related costs and saving has a high probability of being achieved. ~~(Staff Reply Brief at 34.)~~ In Staff's view, a merger costs and saving factor would reduce the regulatory burden of determining the actual amount of costs and savings on an annual basis. Although Staff did not specifically provide in its briefs exactly what ~~if~~ it thought the M factor should be, it did provide data which it extrapolated by using data from the merger case and that which was based upon evidence provided by Staff in this docket. ~~(Id. At 35.)~~

GCI/City's Position

City/GCI recommend the use of an M factor in the price cap formula. Because there is only specific data on merger saving for three months in 1999, City/GCI propose that the M factor by initially established on the basis of the level of savings that Ameritech and SBC Boards of Directors had anticipated when the "transfer ratio" value was set. Applying the 50% ratepayer allocation of savings that the Commission adopted in the Merger Order and Ameritech/SBC's anticipated level of savings, would result in a M factor of 4.8%. Finally, City/CUB suggest that following a review of this modification to the Plan, should the Commission determine that 4.8% M factor be too low or too high, the Commission can adjust the PCI up or down accordingly.

AI's ~~Position~~ Response

AI specifically opposes City/GCI's proposal. The Company notes that making an adjustment now based on the same estimated data presented in Docket 98-0555 would be inconsistent with the plain terms of the Order, which AI states, requires the adjustment be based on actual data. Even more importantly, AI contends ~~is~~ that Dr.

Selwyn's approach to calculating these savings on an estimated basis produced vastly excessive savings amounts in Docket 98-0555. The same problem exists in this docket, since City/GCI is relying on precisely the same analysis. Since the Commission rejected Dr. Selwyn's approach in Docket 98-0555, AI argues that there is no basis for adopting it here. (Merger Order at 147.)

Commission Analysis and Conclusion

The Commission concludes that City/GCI's proposal should not be adopted. We were clear in Docket 98-0555 that merger savings adjustments would not be based on estimates but rather actual merger related savings. As discussed, Staff took the position that actual merger savings will be known in time for the Company's annual filing on April 1, 2004, at which time a one-time adjustment to the price cap index should be made. The Company presented evidence indicating that the actual permanent level merger savings may be known sooner than that. Based on the evidence, the Commission agrees with AI's recommendation that, on an interim basis, actual merger costs and savings continue to be examined and dealt with annually. This conclusion is consistent with the Commission's Order in Docket 01-0302. This approach leaves open the possibility of developing and implementing a permanent one-time adjustment to the regulatory treatment of merger costs and savings prior to the year 2004, if appropriate.

~~We agree with Staff's recommendation that the terms of the merger conditions shall remain in effect until the Commission completes its review of AI's annual filing for the calendar year 2003. The extent of actual merger related savings will be known in time for the Company's annual filing on April 1, 2004, at which time a one-time adjustment to the price cap index should then be made.~~

E. Baskets

1. Generally

Under the terms of the original Plan, non-competitive services were divided into four baskets. Originally each of the four baskets consisted of the following: 1) the Residential basket contained access and Band A, Band B, and Band C usage; 2) the Business basket consisted of business access, Band A through D usage, and certain discretionary services; 3) the Carrier basket consisted of switched access, special access, cellular access and other various carrier services; 4) the Other Services basket contained directory services, directory assistance, operator services, payphones, private lines, discretionary residential services and name and address service in Chicago. Order at 66 and 69. The baskets were structured to ensure that all customer classes benefited equally from price regulation, and, with respect to the splitting of residence services between the Residential and Other baskets, to facilitate the application of the five-year rate cap to basic network access lines and usage. (Order at 68-69.)

The ~~four basket~~ four-basket system has been maintained throughout the life of the Plan; however, the makeup within each basket has changed. As provided for within the Plan, AI may withdraw services from baskets by reclassifying them as competitive. Since the Plan became effective, and including those reclassifications ~~currently~~ formally under investigation in Docket 98-0860, Staff claims that revenues subject to the Plan, i.e. from services within the four baskets, have declined by $350 million. In particular, Staff asserts revenues from within the Business basket have declined by 94%.

2. Proposed Modifications to the Basket Structure

a. Consolidation of Baskets

AI's Position

On a going forward basis, AI proposes that all ~~services which remain under the Plan~~ services that remain under the Plan be consolidated into a single basket. Because many services within the Business and Carrier baskets have been reclassified as competitive and/or because many carrier services are now priced on an incremental cost standard, AI suggests that there is no longer a need for multiple baskets. AI contends there is a benefit to a single basket system. AI asserts that a single basket would allow greater flexibility in structuring discounted service packages for customers and well as permit a meaningful opportunity to restructure rates across customer classes. Alternatively, AI proposes that all residential related services be combined into one basket.

In its Exceptions, AI points out that recent legislative changes support its consolidation proposal. First, since all business services are classified as competitive effective June 30, 2001, there will be no Business basket on a going-forward basis. AI takes the position that this is a material change, since Staff and GCI's/City's opposition to basket consolidation was based in substantial part on the expectation that business services would be returned to the Business basket as a result of Docket 98-0860. In addition, AI points out that the dichotomy between access lines, usage and features which exists under the current basket structure may not be consistent with the General Assembly's current views, given the packages which the new legislation mandates.

In its Initial Brief on Impact of New Legislation, AI maintains its argument that all baskets be consolidated into one. Alternatively, AI asserts that at a minimum the Residence and Other baskets be combined. Under its alternative proposal there would be two baskets, Residence/Other and Carrier. AI alleges that a combination of Residence and Other baskets would not run afoul with the nondiscrimination policy objectives of the original Plan. Further a combination of these baskets would afford the Company with flexibility to adjust rates within the entire universe of residence services. Further, the Company argues that consolidation of these two baskets is necessary because its ability to reduce rates in the Residence basket has been exhausted over the last six years. Consistent with its prior assertions, AI claims that it residence network access line rates are too low and further reductions to them would be inappropriate. Additionally, by combining these two baskets, no longer will the Commission be faced with making a determination of whether certain services should be place in one basket or the other. The Commission therefore would not be required to determine which baskets discretionary calling plans or those mandated by statute properly belong. They would simply be contained within the newly combined Residence/Other basket

Independent of whether all baskets are combined into one, or the Residence and Other baskets are combined, AI does not oppose Staff's recommendation to place the statutorily mandated calling plans into the Residence basket.

Staff's Position

Originally, Staff contendeds that the ~~for~~ basket four-basket system should be maintained. Generally, Staff objects to AI's single basket proposal because of its concern with customer class discrimination. "[C]ustomer class discrimination occurs when a specific class does not receive the rate reduction given to other classes. To avoid such discrimination, the Commission placed residential, business and carrier services in separate baskets. Therefore, when rate reductions are required in an annual filing, each customer class receives similar benefits. Any combining of service baskets eliminates the protection that certain customers currently receive. ~~(Staff Reply Brief at 25.)~~

In its Brief on the Effects of HB 2900, Staff modified its position relative to the makeup of the baskets. First, with respect to the legislatively mandated local service packages, Staff asserts they be placed in the Residential basket. Staff opines that since each package mandated by statute includes access services and that most of the services contained within the statutorily mandated packages consists of services that would, if unbundled, be in the Residential basket, then all of the legislatively mandated packages should be placed therein. Staff alleges that by placing these packages within the Residential basket, the savings to consumers in the future and residential subscribers as a class will continue to receive benefits under alternative regulation. Additionally, placement of the legislatively mandated packages in the Other basket would only serve to frustrate the legislative intent that rates for the packages would continue to result in saving for average ratepayers. Legislative intent would be frustrated if the packages would be placed within a basket, which contain vertical services, which historically have high margins. In theory, Staff asserts, AI could raise prices for the packages over time and still meet the basket pricing constraint by reducing prices of high margin services. Staff contends there is less ability to manipulate or increase the costs of the packages in the Residential basket.

Secondly, Staff now asserts that the Business basket be eliminated. The basis for Staff's new position is 13-502.5(b) of House bill 2900, which provides that:

" (b) All retail telecommunications services provided to business end users by any telecommunications carrier subject, as of May 1, 2001, to alternative regulation under an alternative regulation plan pursuant to Section 130506.1 of this Act shall be classified as competitive as of the effective date of this amendatory Act of the 92nd General Assembly without further Commission review. Rates for retail telecommunications services provided to business end users with 4 or fewer access lines shall not exceed the rates the carrier charged for those services on May 1, 2001. This restriction upon the rates of retail telecommunications services provided to business end users shall remain in force and effect through July 1, 2005; provided, however, that nothing in this Section shall be construed to prohibit reduction of those rates. Rates for retail telecommunications services provided to business end users with 5 or more access lines shall not be subject to the restrictions set forth in this subsection."

As business services are now competitive by operation ~~If~~ of law, Staff concludes there is no need for a Business basket.

~~Staff's Position~~

~~Despite what Staff views as the premature reclassification of certain business services by AI, Staff maintains the need for the four basket system remains. Even if AI's business reclassifications are not found to be improper in Docket 98-0860, Staff contends that the need for a separate Business basket continues given the potential for new business services which could cause a basket to expand significantly. Given~~

Finally, given that access charges are non-competitive services Staff argues that the Carrier basket should remain. ~~Further, Staff claims that the Residential basket must continue in as much as competition does not exist in any meaningful sense for those services.~~

GCI/City's Position

City/GCI also object to AI's modified basket structure proposal. They argue that if AI were given the chance to unilaterally and without constraint shift revenue recovery among all of its services, the protections against Ramsey pricing and the need to provide all consumer classes with rate reduction and innovation would be lost. City/GCI original arguments as why the ~~four basket~~ four-basket structure should remain mirror those made by Staff.

GCI in its Reply Brief on Exception and Initial Brief on the Impact of HB 2900 and Reply Brief on the Impact of HB 2900 argue for the creation of a separate "Statutory" basket for those flat rate service packages mandated under HB 2900. The new section 13-518, requires AI to offer three flat rate residential packages: 1) access and unlimited local calls, 2) access and unlimited local calls and the customer's choice of 2 vertical services, and 3) two lines, access and unlimited local and toll calls, and the customer's choice of 2 vertical services. GCI state that when the Plan was initially established, access and usage were in the Residential basket and vertical services were in the Other basket. GCI note that two of the three mandated packages contain services that can be found in both the Residential and Other baskets. Additionally, GCI note that some packages will also contain services would be considered competitive and noncompetitive. As such, the packages that contain vertical services and additional lines do not clearly fall into one of the existing baskets.

GCI expressed its concern with placing the mandated packages in the Residential services basket. GCI cite to statutory language found in 13-518(a) wherein the legislature states in part, " [I]t is the intent of this Section to provide unlimited local services packages at prices that will result in savings for the average consumer." In the event that the statutory packages are placed within a basket that contains an already existing service, GCI claim that AI could pursue a pricing strategy to raise the access rates so that consumers are driven to packages even if they do not suit their needs. Alternatively, GCI claim AI could increase prices for mandated package within a commingled basket and thus thwart the legislatures intent that packages would result in savings. As such, GCI conclude it is appropriate for the statutorily mandated packages to be place into their own separate basket.

In its Brief on Effect of HB2900 the City also suggests that the Commission create a new basket in which to house the statutorily mandated flat rate services packages. The City notes that the newly mandated packages contain services that traditionally have been found in the Residential basket, the Other basket, as well as services which are competitive and thus outside the scope of the alternative regulation plan. As such, City states that placing flat rate packages in an existing basket would be "akin to trying to force a square pin into a round hole."

AT&T's Position

AT&T agrees with Staff and City/GCI that on a going forward basis, the ~~four basket~~ four-basket system be used. Further, AT&T maintains that AI's rationale for commingling all the baskets into one ~~has~~ had been undermined by the Hearing Examiners' Proposed Order in Docket 98-0860, wherein the Hearing Examiners concluded that AI had prematurely classified all the business services under investigation in that docket. Procedurally, AT&T notes that had the Commission accepted the findings and conclusions in the HEPO, all those services under investigation previously reclassified as competitive, would have been returned to the Business basket. On a more general basis, AT&T takes issue with the proposition that unless a basket contains several services, it should be eliminated. Even if the services at issue in 98-0860 were found to be competitive at the time of reclassification, AT&T argues that it is conceivable that in a developing market, new business services would be created and therefore need a home in the Business basket. Additionally, AT&T

recommends that wholesale services be placed in the same basket as the corresponding retail service, or if the retail service has been declared competitive and been removed from the alternative regulation plan, in the same basket the corresponding retail service would be placed if it were still classified as noncompetitive. AT&T therefore concludes there are multiple reasons for a viable Business basket .

Further, AT&T asserts that the premise of the ~~four basket~~ four-basket structure was to ensure that all customer classes were treated equitably, free from discrimination and cross subsidies. ~~(AT&T Reply Brief at 6.)~~AT&T sets forth the statutory underpinnings behind the ~~four basket~~ four-basket system. Pursuant to the Act, no alternative regulation plan may be adopted which would unduly or unreasonably prejudice or disadvantage any particular customer class. (AT&T Reply Brief at 5 citing 220 ILCS 5/13-506.1(b)(7)). AT&T quotes from AI's Initial Brief wherein AI stated "[t]he [four] basket structure and residential rate protection functioned precisely as the Commission intended. All rate reductions required by the Plan were flowed through equitably to each customer group." (Id. at 6, citing AI Initial Brief at 30.) AT&T concludes that the ~~four basket~~ four-basket structure is a tried and true mechanism to ensure that all customer classes are protected and treated equitably.

In its Initial Brief Discussing the Impact of HB 2900, AT&T continues to call for the maintenance of a four-basket system. Despite the legislature's reclassification of retail business services by operation of law (13-502.5), AT&T maintains its argument that wholesale business services should be placed in the same basket the corresponding retail service would be placed if it were still classified as noncompetitive. As such, AT&T argues, the Business basket would not be empty and therefore it is a viable basket.

b. Calling Plans

Staff~~'s~~ and GCI/City's Position

Staff proposes that all residential calling plans be transferred from the Other basket to the Residential basket. In Staff's opinion calling plans are not truly discretionary services as no customer could make use of the network without obtaining these services. Additionally, Staff argues that by placing calling plans within the Other basket renders the price cap plan less effective at ensuring that benefits are passed on to the most captive customer. City/GCI concur in Staff's proposed treatment of calling plans.

AI's Response

AI opposes Staff and City/GCI's proposal to move calling plans from the Other basket and into the Residential basket. Under the Plan, AI explains, new services are excluded for one year and new residential services are then placed in the Other basket, together with other optional residential services. AI views calling plans as an optional service as they offer customers choices they previously did not have. AI contends its interpretation of calling plans, as an optional service, is consistent with the FCC definition of a new service under its price cap plan. Finally, AI suggests that its view is consistent with that of the Commission's in that the Residential basket was intended for basic services while the Other basket was intended for discretionary services.

c. Elimination of Certain Services from Baskets

AI's Position

AI recommends that 911 services, UNEs, wholesale and carrier access charges be excluded from the operation of the index, i.e. excluded from the basket structure. AI asserts that by previous Commission order, 911 services and UNEs have been excluded from the Plan. (AI Initial Brief at 46, citing Order and 96-0486/0569.)

AI argues that because TA96 requires that UNE prices must be set at TELRIC, plus an appropriate allocation of common overhead costs, it remains appropriate to exclude UNE services from the basket structure. With respect to wholesale services, AI argues said services should be treated similarly to UNEs, because, pursuant to TA96, wholesale services must also be priced based upon a cost standard. AI contends that it is entitled to set its wholesale rates based on a costs standard and TA96 does not contemplate any further reductions. ~~(Id. At 47.)~~ AI makes a similar argument with respect to switched carrier access rates. Because the Commission requires switched carrier access rates to be set at LRSIC plus common overhead allocation, further potential decreases inflicted by the basket structure would be impermissible. AI asserts that further downward adjustments based on the price index would result in carrier access ~~rates which~~ rates that are below the ~~level which~~ level that the Commission has already found to be reasonable and equitable. (i.e. LRSIC plus common overhead allocation.)

Consequently, AI proposes those services which the Commission has previously excluded from the basket structure continue to be excluded, and wholesale and carrier access charges be excluded on a going forward basis. Finally, AI contends that the cost changes reflected in the X factor do not translate into changes in LRSIC/TELRIC costs or common costs since the X factor reflects changes in actual operating costs while LRSIC and TELRIC already assume the use of forward looking technologies and operating practices. According to AI, applying the X factor to carrier access charges or UNEs would improperly double count productivity gains.

GCI/City's Position

City/GCI reject AI's proposal to eliminate UNEs, wholesale services and carrier rates from the price cap. City/GCI reject as a premise their exclusion because they are based on LRSIC and TELRIC studies. Because these rates do contain a contribution towards common overhead costs, cost reductions anticipated under the Plan could not result in prices lower than LRSIC or TELRIC costs. However City/GCI state the Plan could serve to reduce overhead costs. ~~City/GCI Reply Brief at 33.~~ Further, they note that common overhead costs are exactly the costs that would be reduced as a result of general productivity and costs savings measures. ~~(Id.)~~

City/GCI witness TerKeurst refutes AI's claim that ~~includes~~ including UNE, wholesale service and carrier rate in the price cap will result in double counting of productivity gains. She claims that there is no evidence to support AI has accurately predicted every change, including technology changes, input levels and input mixes that will occur for these services.

AT&T's Position

AT&T also addresses the issue of the make-up of certain baskets. First, with respect to the Carrier basket, AT&T proposes that UNEs, Interconnection and Transport, and Termination services should be added and that carrier access services should remain therein. AT&T contends that continuing to include carrier access services in the price cap mechanism is consistent with forward looking cost based pricing of switched access services. AT&T posits that including carrier access services in the price cap mechanism will ensure that switched access rates properly reflect cost reductions as AI's cost of providing access services declines over time.

AT&T contends AI's arguments regarding why certain services should be excluded from the Alternative Regulation Plan are at best abbreviated. AI's stated rationale for excluding UNEs from the price cap mechanism is that the Commission excluded UNEs from the Plan in its Order in 96-0486/0569 because the federal Act requires that UNEs be set at TELRIC plus an appropriate allocation of shared and common costs. AT&T states that although the Commission in its Order in Dockets 96-0486/0569 declined to include UNEs, interconnection, termination, and transport services in the Plan, it did so with the caveat, "at the present time." AT&T argues that the language "at the present time" used by the Commission means that the Commission is free to reconsider the issue. AT&T asserts now is the time to revisit the issue.

AT&T contends that the reasons the Commission found for excluding UNEs from the Plan before are no longer in existence. One reason to no longer exclude such services is the extremely generous shared and common cost markup AI is allowed to assess to UNEs. Further AT&T asserts, customers do not have competitive alternatives for UNEs; hence, UNEs are appropriately classified as noncompetitive. With respect to AI's contention that UNE prices must be set at TELRIC plus common overhead costs, AT&T argues that the rates adopted by the Commission in the TELRIC Order are not price floors but rather price ceilings. Because the price cap formula is designed to capture AI's efficiency gains, AT&T asserts there is no reason that AI's efficiency gains should not also flow to the UNEs, interconnection and transport and termination services. AT&T argues that the Commission should not deprive CLECs and their customers of these efficiencies. AT&T concludes that UNEs should be included in the Carrier basket.

With respect to carrier access services, AT&T contends that AI misstates the Commissions order in 97-0601/0602 ("Phase II Order") in support of its position to exclude carrier access services from the price cap formula. ~~AT&T Reply Brief at14.~~ AT&T contends that the Commission did not set AI's carrier access rates *at* LRSIC plus common overhead allocation, but rather the Commission required AI to set carrier access rates at LRSIC, and then gave AI the right to include in its carrier access rate an allocation of shared and common costs not to exceed, but be capped at 28%. (Id at 15.) AT&T supplied the following quote from the Phase II Order:

> Accordingly, we adopt the shared and common cost percentages for switched access rate elements contained in AT&T Gebhardt Cross Ex. 1A, page 3, and conclude *that the maximum shared and common cost contribution shall be 28.86%* for both Ameritech's and GTE's cost-based switched access rate elements. Order dated March 29, 2000, ICC Docket Nos. 97-0601/0602, p. 51 (emphasis supplied).

AT&T asserts that operative word in the quote above is "maximum." Staff witness Koch also agreed that the Phase II Order does not *set* the shared and common cost allocation at 28.86% but, rather, caps the shared and common cost allocation.

AT&T counters AI's assertion that any reductions to its LRSIC costs and common overhead allocations for carrier access services can be reflected via updated cost studies. AT&T points to GCI witness TerKeurst's testimony wherein she stated that it took almost three years to litigate dockets 97-0601/0602. AT&T's point is that the delay associated with 97-0601/0602 demonstrates the process of investigating and litigating AI's cost studies is almost inevitably a lengthy, contentious and resource intensive process for both the Commission and the interested parties. As such, AT&T suggests the process of reviewing or updated AI's costs studies are not as simple or expeditious as AI contends.

AT&T agrees with CUB ~~in~~ that price cap provisions could provide a convenient, low cost and routine approach to updating rates derived initially through cost studies, thus avoiding or deferring lengthy and contentious proceedings to evaluate cost studies and update rates for these services, and furthering the goal of reducing regulatory costs. ~~(AT&T Reply Brief at 15, citing CUB Initial Br. at 67.)~~

AT&T also agrees with GCI witness Terkeurst relative to what it views as AI's inability to accurately predict future changes in operating costs in LRSIC/TELRIC calculations. AT&T's asserts that application of the PCI to carrier access charges will not result in double counting of costs. AT&T therefore concludes that such services should be included within the Carrier basket and customers purchasing those services should receive the benefits of the price cap mechanism. ~~(ST&T Reply Brief at 7.)~~

AT&T argues that wholesale services should continue to be included within the Plan. While AI contends that nothing in TA96 contemplates further reductions, AT&T posits that nothing in the federal Act precludes further reductions to wholesale rates. AT&T notes that AI itself concedes that wholesale rates must decline with their retail counterparts. Thus AT&T concludes, to the extent AI experiences cost reductions, wholesale services should also benefit from those reductions through the price cap mechanism. ~~AT&T Reply Brief at 13-14.~~ Moreover, AT&T explains, wholesale services have been included in the Alternative Regulation Plan for almost six years since the Commission adopted its Wholesale Order. AT&T contends the Commission should continue to include wholesale services within the Alternative Regulation Plan for the same reasons carrier access charges and UNEs should be included.

AT&T proposes a further modification with respect to wholesale services. AT&T recognizes that although wholesale services being provided by AI are in fact carrier services, it is more appropriate that said services ~~follow~~ be placed in the same basket as their retail companion. Finally, AT&T notes that where a wholesale service is included within the same basket as the corresponding retail service, the same consumer classes will be addressed independent of their customer classes. This, AT&T concludes, will allow customer classes to be treated equitably and free from discrimination and cross subsidies.

Commission Analysis and Conclusion

The Commission concludes that the current ~~four basket~~ four-basket structure is no longer viable ~~should be continued~~ on a going forward basis. With the passage of HB 2900, the make-up of the current basket system requires some modification. AI's arguments for a modification from a four-basket system to a single basket ~~however~~ system are not persuasive. ~~Since the opening of Docket 98-0860, AI returned all the residential services which were previously reclassified as competitive to a non-competitive status. Serious questions have been raised as to the propriety of the business services AI reclassified as competitive. Under the Plan, provisions were made allowing for services to be returned to a noncompetitive status as well as new services being added to baskets.~~ The elimination or consolidation as proposed by AI does not further the goals of protecting consumers ~~a customer class~~ against cross subsidies. The Commission finds that a ~~four~~ multiple basket structure ~~continues~~ will ~~to~~ ensure that all customer classes are treated equitably, free from discrimination and cross subsidies. We conclude that a three-basket system is appropriate on a going forward basis. The baskets are Residence, Other, and Carrier. The contents of each basket will remain as they have been, except as provided for below.

First we conclude that with the passage of HB 2900, and in particular Section 13-502.5 of the Act, the Business basket shall be eliminated and any services in the Business basket that are still subject to alternative regulation should be placed the Other basket. Inasmuch as all business services have been declared competitive pursuant to Section 13-502.5 of the Act, the number and value of services remaining in the Business basket is certain to be so small as to warrant elimination of the basket for purposes of administrative convenience. With the elimination of retail business services from the Alternative Regulation Plan, the concern of customer class discrimination maybe somewhat lessened. AT&T's attempt to revive the Business basket by placing wholesale business services in the same basket the corresponding retail service would be placed if it were still classified as noncompetitive is rejected.

We further conclude that AI has properly treated voluntary residential calling plans (SimpliFive and CallPak) as new services and has properly assigned them to the "Other" basket. These particular calling plans are optional to the customer and are provided by the company on a voluntary basis. A customer is not required to enter into a calling plan before usage may begin and therefore a customer's decision whether to enter into a calling plan is discretionary. A customer may refrain from obtaining the voluntary plans and remain simply with residential access plus basic service, or obtain one of the mandate packages. The mechanisms currently in place for new services and how they are to be treated within the PCI shall remain on a going forward basis. Given the new ability to choose a statutorily mandated calling plan the significance or impact of the two voluntarily offered plans described above on either the ~~Residence~~ Residential or Other basket will undoubtedly be ~~severely~~ diminished.

We conclude that 911 services should continue to be excluded from the operation of the price cap index. 911 services have essentially been set at cost to promote public safety objectives. Price decreases would ~~then~~ have the effect of lowering rates below costs. We also recognize that price changes to 911 services would be difficult for municipalities to manage as 911 surcharges are typically approved through referenda. As such, these charges cannot be readily modified.

With respect to UNEs, wholesale and carrier access charges, the Commission concludes said items shall not be excluded from the operation of the index and shall be included within the basket structure. UNEs shall be made apart of the Carrier basket. Wholesale rates shall remain apart of the Carrier basket. Carrier Access Services shall remain in the Carrier basket.

Ultimately, we are persuaded by the positions of AT&T and City/CUB with respect to the inclusion of UNEs, wholesale services and carrier access rates within the price cap mechanism. Our conclusions relative to these issues ~~is~~ are uniform and consistent.

Though we had previously withheld application of the price cap mechanism to UNEs in the TELRIC Order, we agree that now is the appropriate time to reassess our position. AI is the beneficiary of generous shared and common cost markups, which AI is allowed to assess to UNEs. Further, customers do not have competitive alternatives for UNEs and therefore UNEs are appropriately classified as noncompetitive. For these reasons we conclude that it is appropriate to reassess whether to include UNEs within the price cap mechanism.

With respect to UNEs, the rates adopted by the Commission in the TELRIC Order shall be considered as price ceilings and not as price floors. Nothing in the 1996 Telecommunications Act or FCC's rules mandates static rate levels for UNEs. It would be illogical to assume that fixed UNE rates continue to be cost-based for several years. To the contrary, UNE costs, and therefore rates, are expected to be exposed to the same exogenous factors such as productivity gains, changes in input prices, and inflation as a whole, that rates for retail services are exposed to. The Commission agrees with AI that the 1996 Telecommunications Act and the FCC's Orders require UNE rates to be cost-based at all times. However, inclusion of UNEs into the ~~carrier~~ Carrier basket does not violate the federal requirements. Actually, it could be argued that TELRIC-based UNE rates are only cost-based at the time such rates are developed. For example, it is questionable whether UNE rates developed in the TELRIC Order several years ago are still cost-based and forward-looking today. We disagree with AI's contention that application of the X-factor would result in double counting of productivity gains. AI is correct that TELRIC is forward-looking and assumes the most efficient network design. Such forward-looking standard, however, should not be interpreted in a way that allows AI to keep its UNE rates fixed until its actual network design "catches up" with the assumed TELRIC network design. Such a regime would be contrary to the intention of forward-looking costs. Forward-looking costs should be forward-looking not only at a particular snapshot in time, but rather during the lifetime of such UNE. Going forward, we view it appropriate to include UNEs in the price cap plan to ensure UNE rates stay closer to their actual costs. We acknowledge that nothing short of an annual review of UNE rates would ensure total compliance with TELRIC-based rates at all times. However, the benefits of such an exercise are likely to be outweighed by the resources required for it. We view the inclusion of UNEs into the price cap plan as an appropriate measure to keep UNE rates cost-based in intervals between the points in time when the Commission approves UNE rates.

As with UNEs, the carrier access rates adopted by the Commission in its Phase II Order should be considered as a price ceiling and not as a price floor. The text of the order cited above by AT&T clearly states the intention of the Commission in this regard. AI's interpretation is flawed.

We are similarly persuaded to continue to include wholesale rates within the price cap mechanism. Our Wholesale Order does apply an avoided costs standard, similar in effect to those costs standards as imposed upon UNEs and carrier access rates. However, we note that there is nothing within the federal Act to preclude further reductions to wholesale rates. We agree with AT&T in that to the extent AI experiences cost reductions, wholesale services also benefit from those reductions by operation of the price cap mechanism.

The Commission is now presented with the task of determining which, if any, of the existing baskets would be an appropriate location for the statutorily mandated calling plans found in 13-518(a)(1)-(3) of the Act. As noted above by the parties, taken as a whole, the three mandated plans contain services traditionally found in two baskets and some services that are outside of the Plan, as certain services are considered competitive services. One consistent element contained within each of the mandated plans is residence network access. This particular element has traditionally been found within the Residential basket and is the cornerstone of residence services, without which no other type of service is possible. Each of the three mandated packages bundle residence network access with other services. In other words, you may not obtain one of the three packages without network access. Though two of the three mandated packages contain services not traditionally found within the Residential basket, we agree with Staff and the Company that these plans be placed within the Residential basket.

Staff correctly points out that each package mandated by statute includes access services and that most of the services contained within the statutorily mandated packages consists of services, if unbundled, would be in the Residential basket. Though not a perfect fit, including all the mandated packages within the Residential basket does make sense. Each package contains network access. Each package contains local usage. These statutorily mandated packages can be distinguished from SimpliFive and CallPak or other voluntarily provided calling plans that the Company may offer at its discretion. Voluntary plans may bundle network access with usage or ~~it~~ they not. However, the mandated packages may not be offered without offering network access. As stated above, network access is the core element of residence service and therefore should not be extracted from the Residential basket simply because other service(s), bundled with network access may not neatly fit into the Residential basket. Further, we agree with Staff that by placing the mandated packages within the Residential basket, savings to consumers in the future and residential subscribers as a class, will continue under alternative regulation. Admittedly, by placing the mandated packages within the Residential basket together with other existing services, the Company has some level of flexibility when it comes to price. It may lower prices of other services in order to raise prices of mandated services. The Company however, is constrained within the Residential basket. As discussed immediately below, the likelihood of the Company decreasing the price of services currently found in the Residential basket, in order to increase the price of mandated packages, is significantly reduced given the lower margins of services historically found in the Residential basket. Therefore, we conclude the statutorily mandated calling plans be placed within the Residential basket.

GCI/City's suggestion of adding a new basket just for the mandated packages is interesting but is rejected. After HB 2900 was passed the parties were afforded an opportunity to comment on the impact of the new legislation on alternative regulation. Some parties acknowledged that the newly mandated plans would be very popular with consumers. No party indicated that the mandated plans would not be popular. Certainly the legislature must have envisioned the mandated plans would be well received. Assuming the mandated plans become as popular as many believe, removal of the those plans from the Residential basket and into their own basket will have consequences. While it is true that should theses mandated services be placed into their own baskets, there may be a greater likelihood for reductions in price over time due to the workings of the formula, i.e. the effect of the consumer dividend and productivity differential, it is equally true that core residential services will become fragmented within two baskets, ~~Residence~~ Residential basket and GCI/City's proposed "Statutory" basket. In particular, a separate Statutory basket will cause the fragmentation of residential network access. ~~Residential network access is the foundation on which all other residence services are built.~~ To divide residential network access between to baskets, would only serve to weaken or dilute its position within each basket. GCI/City also argue that by placing the mandated plans within their own basket, the Company will have no ability to manipulate their prices. GCI/City suggest that unless the mandated plans are removed from the Residential basket and placed within their own basket, the Company could raise the prices of the mandated plans and offset those increases with decreases to high margin services contained within the same basket.

~~We conclude that~~As stated above, the ability to manipulate or increase the costs of services found in the Residential basket, including the mandated packages, is significantly lessened given the lower margins of other services historically found in the Residential basket. This is true~~,~~ especially when compared to those discretionary services found in the Other basket. Therefore, we reject GCI/City proposed addition of a Statutory basket.

We also reject the Company's alternative proposal of combining the Residential and Other baskets. Consistent with our conclusion immediately above, placement of traditional residence services contained with the Residential basket and the legislatively mandated packages together with services found in the Other basket would only serve to frustrate the legislative intent that rates for the packages would continue to result in saving for average ratepayers. Legislative intent would be frustrated if residence services including the mandated packages would be placed within a basket that contain vertical services ~~which~~ that historically have high margins. As Staff correctly points out, the Company could easily raise prices for the packages over time and still meet the basket pricing constraint by reducing prices of high margin services.

d. Reinitialization of APC & PCI

In our Order, the Commission set both the API and PCI equal to 100 (Order at Appendix A.), Section 2(a). Staff and City/GCI recommend that these indices, which have declined over time, be reset to 100 on a going forward basis. According to Staff, reinitialization will have the effect of affording the Plan the maximum capacity to affect rate changes. Staff acknowledges that reinitialization will primarily affect the Carrier Basket. Similarly City/GCI, state that absent reinitialization, customers purchasing services from the Carrier basket, such as switched access services and unbundled network element ("UNEs") (assuming that carrier access and other carrier services are included in the basket as GCI recommends), would not benefit from efficiency gains experienced by AI in the future. Said customers would receive no benefit because the API for the Carrier Basket is already well below the PCI. Further City/GCI contend that any rate adjustments resulting from an overall review of AI's earnings must be reflected in a reduced API/PCI. City/GCI agree with Staff that reinitializing the API and PCI to 100, would give the Plan the maximum potential to affect rates.

AI opposes the reinitialization of the API/PCI indices. By reinitializing, AI argues, you effectively eliminate the "headroom". Headroom occurs when rates in particular baskets decline more than the index would have required. Reinitializing the API/PCI combined with subjecting carrier access rates to the price index, would, AI contends, require further decreases to carrier access rates in the annual price cap filing. ~~(Ameritech Reply Brief at 38.)~~ This result, AI concludes, is inconsistent with the Commission's Order in Docket 97-0601/602. ~~(Id.)~~

Further, AI states, there is little likelihood it could offset the headroom associated with carrier access rate decreases with increases in other carrier rates. AI notes that other services within the Carrier basket are incapable of being increased as they would require another TELRIC/wholesale (resale) pricing proceeding. Additionally, AI ~~states~~ points out that it has~~d~~ not made any changes to the basket since it developed its headroom in 1997.

Commission Analysis and Conclusion

The Commission concludes that the API/PCIs in the existing Plan should not be reinitialized on a going forward basis. Reinitialization will effectively eliminate the headroom that ~~which~~ has been achieved by AI during the initial term of the Plan. Reinitialization of the baskets would serve as a disincentive to AI to operate efficiently in the future. However, the API for the Carrier basket must be adjusted as a result of adding UNE services to the basket. The calculation to adjust the API of the Carrier basket shall be similar in from to that proposed by AI for combining the API of the service baskets in this proceeding, with the existing API for UNE services being set at 100 and then weighted against the existing API and revenue for the basket.

F. Earnings Sharing

GCI/City's Position

City/GCI propose that the Commission add an earnings sharing component to the Plan on a going-forward basis. City/GCI note that, in approving a pure price cap form of regulation, the Commission stated that it would reconsider the evidence and policy considerations for earnings sharing in future review proceedings. (Order at p. 51.) City/GCI argue that the evidence in this docket demonstrates that AI's earnings have been excessive under the existing plan, and that ratepayers have received no benefit from these excess earnings. City/GCI assert that the high earnings experienced by AI could be the result of an incorrectly set price cap index, unexpected economic conditions, improper exercise of market power, improperly classified services and irresponsible or poorly managed service performance. In City/GCI's view, earnings sharing can "balance risks, incentives and rewards in the overall regulatory mechanism" and provide consumers with some protection from unexpected results. City/GCI also contend that earnings sharing lessens AI's incentives to increase earnings by sacrificing service quality or improperly reclassifying services as competitive because its actions are still subject to some review and it does not keep all of the benefits of alternative regulation, but shares them with consumers.

City/GCI recommend the following parameters of an earnings sharing provision:

- A benchmark rate of return would be set 200 basis points above the adopted weighted average cost of capital for AI;
- A cap on AI's rate of return would be set at 600 basis points above the adopted cost of capital, thereby creating an absolute after-sharing limit on AI's rate of return;
- Any earnings between the benchmark and cap rates of return would be shared on a 50/50 basis between shareholders and ratepayers and any earnings above the cap rate of return would be returned entirely to customers;
- Revenues from all services that would be included in a revenue requirement determination under cost-of-service regulation would be included in the revenue sharing calculation, except that services for which the Commission has found that AI does not retain significant market power could be excluded if all related expenses and investments were also excluded;
- The customer's portion of any shared earnings would be distributed as a one-time credit on their bills during one or more months in the following year; and

- The earnings sharing provision would require an adjustment for a year during which the prior year's earnings above the benchmark are distributed to customers, to prevent the shared earnings from incorrectly depressing current year earnings.

AI's Position

AI opposes adoption of an earnings sharing provision. AI contends that earnings sharing brings with it all of the issues and baggage associated with rate of return regulation: debate over depreciation rates; extensive reporting and monitoring of AI's investments, rate base and profitability; prudence reviews; and continuing debates over the level of profits AI~~'s~~ is earning and how much it should be allowed to keep. Thus, AI argues that earnings sharing does not break the link between AI's cost and rates. AI views divorcing costs/earnings from rates as a critical component in price regulation. AI further contends that earnings sharing would result in higher, not lower, regulatory costs and delay.

AI also argues that earnings sharing plans blunt the efficiency incentives of price regulation. Once the 50% sharing threshold has been reached, efficiency incentives are reduced dramatically and they are eliminated altogether once the cap is reached. Moreover, because GCI's accounting adjustments flow through in rate reductions the equivalent of 1,311 basis points in earned return, AI asserts that it would be required to share before its actual earnings ever reached a reasonable level. Thus, AI contends, many of the most important behavioral benefits of price regulation will be lost.

AI further argues that earnings sharing is fundamentally inconsistent with the Commission's decision in 1994 ~~to~~ that allows AI to assume responsibility for capital recovery. AI states that the debate over depreciation expense in this proceeding clearly demonstrates why depreciation freedom and earnings regulation are incompatible. Moreover, AI notes that City/GCI propose that whatever decision the Commission makes on depreciation issues in this case would be frozen for the next five years to calculate sharable earnings, absent another Commission proceeding. Thus, if the Commission adopts City/GCI's earnings sharing proposal, AI argues that the Commission will de facto be back in the business of prescribing AI's depreciation rates. Consequently, AI opines, the Commission is no better able to fulfill its side of the regulatory bargain now – (i.e., to ensure full capital recovery of long-lived plant through prices over the next 20-30 years) -- than it was in 1994. AI contends this is the policy dilemma, which the Commission found unacceptable in 1994, and AI states that GCI had proposed no solution to this dilemma.

AI opposes City/GCI's view that earnings sharing is a "safety net" in the event the index is misspecified or as a means of controlling for the impact of economic conditions. AI argues that the Commission has now had five years of experience with the key financial components of the index. AI argues the index was not misspecified in 1994 and there is no reason to believe it will be misspecified on a going-forward basis. AI further contends that the impact of economic conditions is something that the Commission should not attempt to control. If the economy is healthy and there is strong demand for AI's services, then AI will benefit. If the economy weakens and demand for AI's services falls off, then AI will suffer. As long as the relationship is symmetrical, AI contends, the Plan is appropriate and there is no problem that ~~which~~ needs to be "fixed". AI further disputes City/GCI's claim that earnings sharing is necessary because the AI's earnings levels prove that the annual rate reductions under the index have been "grossly insufficient". AI argues that the X factor was, if anything, too high and that this evidence is undisputed in the record.

AI also disputes GCI's claim that earnings sharing would lessen AI's incentives to inflate earnings through cost-cutting measures that harm customers, such as service quality. AI notes that there is no evidence in this record that AI intentionally cut costs associated with the provision of service to inflate its earnings. AI contends the loss of installation and maintenance personnel in 1999 had nothing to do with any of its initiatives. Moreover, AI points out that there is no economic evidence to support the theory that either earnings sharing or rate of return regulation lead to higher quality service. AI argued that, in fact, earnings sharing would make it more difficult to respond to and correct service problems when they do arise.

Furthermore, AI contends that it is legally improper to apply earnings sharing to both competitive and noncompetitive services. Section 13-506.1, by its terms, is limited to noncompetitive services. In AI's view therefore, only earnings on noncompetitive services can be shared. In order to calculate earnings on noncompetitive services, the Commission would have to accept a cost allocation methodology comparable to what AI presented. Furthermore, AI points out that noncompetitive services today are earning well below any reasonable view of AI's cost of capital and that it is highly unlikely that these earnings would increase to a level where GCI's earnings sharing benchmark would ever be triggered. Under these circumstances, AI argues that the administrative costs associated with monitoring earnings and performing the requisite allocations between competitive and noncompetitive services cannot be justified.

Finally, AI contends that the time for earnings sharing had already come and gone by 1994. Many regulators in the late 1980's and early 1990's viewed earnings sharing as a comfortable transitional mechanism between rate of return regulation and pure price regulation when price regulation was new and was perceived to be risky. However, AI argues that that period has long since passed. The Company points out that even regulators who adopted earnings sharing early on – (e.g., the California PUC and the FCC), on whose plans Ms. TerKeurst modeled her proposal -- have since moved on to pure price regulation.

Staff's Position

Staff also opposes adoption of earnings sharing. According to Staff, earnings sharing represents double regulation. Adding an earnings sharing component to price cap regulation would mean that both AI's prices and earnings would be regulated. Moreover, Staff agrees that earnings sharing would bring with it all the problems associated with rate of return regulation. Further, Staff contends that earnings sharing is impossible to implement in any meaningful fashion when some services are subject to competition while others are not. In Staff's view, imposing earnings sharing on the entire company would mean that subscribers of noncompetitive services would inappropriately share the risks and rewards of AI's management decisions in the competitive area. Staff takes the position that noncompetitive service customers are fully protected by the index and that problems stemming from competitive classifications should be addressed directly, not through the adoption of earnings sharing.

Commission Analysis and Conclusion

The Commission concludes that GCI's earnings sharing proposal should not be adopted. Earnings sharing was reviewed at length in 1994 at which time we concluded that it was not an appropriate component of the Plan. GCI's proposal in this proceeding is identical to what was recommended by Staff in 1994. We find that earnings sharing presents all of the same problems now that it did in 1994. Fundamentally, earnings sharing prevents the Commission from delinking AI's cost and rates and continues too many of the negative aspects of rate of return regulation. As a result, earnings sharing compromises the Commission's core regulatory objectives relative to this Plan and will not be adopted. For the reasons propounded above, and by Staff and the Company, we reject the addition of an earnings sharing component to the Plan.

G. Monitoring and Reporting

Section 13-506.1(d) of the Act provides, in relevant part, that:

> Any alternative from of regulation granted for a multi-year period under this Section shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented.

Staff and GCI/City's Position

Staff contends pursuant to statute, monitoring and reporting requirements must remain if the Commission is to extend AI's Alternative Regulation Plan. The information supplied by AI through the monitoring and reporting requirements is valuable to the Commission, the Staff and the public in determining whether Ameritech is complying with the conditions of the Alternative Regulation Plan. ~~(Staff Ex. 4 at 10-11.)~~

Staff asserts that reporting requirements are intended to "document that the requirements of the plan are being properly implemented. Therefore, every requirement or condition of the alternative regulation plan should be addressed in these reports." (Staff Ex. 4 at 10.) Without reporting and monitoring requirements, Staff argues the Commission, its Staff, and the other parties with a legitimate interest in whether ~~Ameritech~~ AI is complying with its obligations under the plan would be unable to make an informed assessment.

Further, Staff asserts, the individual reporting requirements continue to be meaningful in a regulatory sense. Similarly, Staff contends that in light of the Commission's ongoing authority to rescind alternative regulation plans which are failing to satisfy the statutory requirements for such plans, see, 220 ILCS 5/13-506.1(e), AI cannot assert that it should not be required to produce basic financial information especially, if, the information is not available from other sources. ~~(Staff Ex. 4 at 17.)~~ Lastly, Staff argues that while it is true that Ameritech files some information in price cap filings, it is also true that there should be a single complete source of information regarding ~~Ameritech's~~ AI's performance under the plan, which the price cap filings are not.

Annual monitoring and reporting requirements were imposed on AI by the 1994 Order and are fully set forth below:

1. Total Company and Illinois jurisdictional rate base for the preceding calendar year adjusted to reflect regulatory treatment ordered in Dockets 92-0448/93-0239.

2. Total Company and Illinois jurisdictional operating revenue and expenses for the preceding calendar year adjusted to reflect the regulatory treatment ordered in Dockets 92-0448/94-0239.

3. Other income and deductions, interest charges, and extraordinary items for the preceding year (with explanations);

4. Preceding calendar end of year capital structure;

5. Calculated total Company and Illinois jurisdiction return on net utility rate base and total Company return on common equity;

6. Statement of Sources and Applications of Funds for the preceding calendar year;

7. Description of proposed projects and amounts to be invested in new technology (regarding the Company's $3 billion infrastructure investment) for the current calendar year and a comparison with the actual projects and amounts invested in new technologies during the preceding calendar year;

8. Calculation of the current price cap index and actual price indexes including the formulas used, the inflation factor and its source, the general adjustment factor, the exogenous factor and a description of its calculation, and the service quality component and a description of its calculation;

9. A description of new services offered in the preceding calendar year, including the price of each and its effect on the calculation of API;

10. Demand growth by revenue - basket in the preceding calendar year;

11. Summary of price changes initiated under the Alternative Regulatory Plan in the preceding calendar year;

12. A demonstration that Section 13-507 of the Act has been complied with during the preceding calendar year;

13. A summary report on Ameritech's quality of service during the preceding calendar year; and

14. A summary report on the exogenous events that affected the exogenous factor of the price cap index formula.

(Alternative Regulation Order, Appendix A at 7-10.)

Staff and City/GCI~~,~~ argue that the Commission should order all of the existing reporting and monitoring requirements be continued. Even where information may be duplicative, they contend that there should be a single complete source of information regarding AI's performance under the Plan. Staff also recommends that a schedule for the next review proceeding be specified in the Commission's Order in this proceeding.

AI's Position

AI contends that the existing requirements could be streamlined on a going-forward basis to reduce the costs of regulation, without any loss in appropriate Commission oversight capabilities. Specifically AI objects to the form of the

Infrastructure report and states that it need not be retained if the infrastructure investment commitment is not retained.

First, AI proposes items 1-6, which are earnings-related in nature, be eliminated because they are not appropriate in a price regulation plan. AI notes that the Commission's stated rationale in 1994 for requiring this information was that high earnings could provide an "early warning" that the productivity offset may have been misspecified. In practice, however, the AI asserts that the productivity offset was not misspecified and that there is no reason to believe that it will be misspecified going forward. Second, AI submits an annual report on March 31 of each year which details it's financial performance over the preceding calendar year sufficiently sets forth other information previously required. AI contends that items 8-11 and 13-14 are unnecessary because those items are addressed in the annual price cap filings.

Finally, the 1994 Order requires an annual demonstration that AI has been in compliance with Section 13-507 of the Act and the Aggregate Revenue Test during the preceding year. AI states that it had no objection to continuation of this reporting requirement, if the Commission found it useful.

AI also recommends that the Commission not establish another predetermined, formal review proceeding in its Order in this proceeding. AI points out that the Commission provided for this current review in large part because it had had no prior experience with price regulation prior to 1994; and, even on a national level, pure price regulation plans (i.e., plans without earnings sharing) were relatively new. The Company argues that price regulation is now the rule, rather than the exception; that this proceeding provides ample opportunity to fine-tune any components of the Plan which did not meet the Commission's expectations; and that, given the time and resources which this proceeding has consumed, there should only be a second review proceeding if it proves to be necessary. AI argues that Section 13-506.1(e) provides the Commission and all parties ample authority to initiate or request an investigation if the Plan does not appear to be functioning properly in the future or if there are unexpected marketplace or economic developments. However, to facilitate the Commission's monitoring of the two key financial components of the index (i.e., GDPPI and the X factor), AI agrees to provide updated information and/or studies relative to these factors in 2007, at the time AI submits its annual price cap filing for 2006, at which point the Plan would have been in effect for another five-year period.

~~Staff and City/GCI, takes the position that the Commission should order all of the existing reporting and monitoring requirements be continued unchanged. In the absence of reporting and monitoring requirements, Staff contends that the Commission, the Staff, and the many parties with a legitimate interest in whether AI was complying with its obligations under the Plan would be unable to make an informed assessment. Staff also argues that all of the individual reporting requirements continue to be meaningful in a regulatory sense. Even where information may be duplicative, Staff contends that there should be a single complete source of information regarding AI's~~

~~performance under the Plan. Staff also recommends that a schedule for the next review proceeding be specified in the Commission's Order in this proceeding.~~

Commission Analysis and Conclusion

The Commission concludes that the reporting requirements associated with this Plan should be retained. The Commission, Staff and other parties have a legitimate interest in determining whether AI is complying with its obligations under the Act. The information supplied by AI through the monitoring and reporting requirements is a critical tool for determining whether AI is complying with the conditions of the Alternative Regulation Plan. We acknowledge that in certain limited instances, reporting requirements may be duplicative. While we agree with AI that one of the statutory goals of alternative regulation is to reduce regulatory costs where practicable, we are persuaded by Staff's position that there should be a single complete source of information regarding Ameritech's performance under the plan.

H. One-Time Credits or Refunds

Staff's Position

Staff proposes two one-time credits or refunds be required as part of the Commission's final Order in this proceeding. First, Staff contends that a credit or refund is required to correct AI's use of an improper definition of irregular service installation. Staff objects to the inclusion of orders for vertical services in AI's reports relative to installation within five days, and contends that these reports should be limited to network access lines. Staff believes the Company has applied an inappropriate definition of "installation" performance for that measure. It notes that Part 730.540(a), which is the foundation for the performance benchmarks in the Alternative Regulation Plan, states the following about installation requests: "The local exchange carrier shall complete 90% of its regular service installation within five working days after the receipt of the application, unless a later date is requested by the applicant." Staff believes the term "regular service installations" should not be construed to mean vertical services and should relate only to the provisioning of regular telephone service, i.e. dial tone. Vertical features, such as Caller ID, Three-way Calling or Call Forwarding, are supplemental or added features to dial tone service and Staff considers requests for such services to be "change" orders. So too, Staff claims, AI's tariffs show that vertical services are "optional" or "custom" services and not regular service.

Yet, Staff contends, somewhere between the advent of vertical services and today, the Company decided to add vertical services to their reporting of "regular service installations" performance data to this Commission.

Staff notes that AI witness Hudzik testified that the success rate for meeting the Installation within five days requirement for vertical services is probably "99%", and perhaps higher, (Tr. 1935). Staff also notes that with vertical services removed from installation figures. AI witness Hudzik testified that AI's success rate in 1999 was "between 88 and 90 percent." (Tr. 1938) For the period of June, July and August of 2000, AI's rate for meeting the installation requirement, including orders for vertical services, was between "96.5 and 98.3" percent. Staff points out that according to Hudzik, with vertical service orders excluded the Company's performance "would have been in the 70 percent range." (Tr. 1939) Staff contends this evidence makes clear that AI's actual performance in relation to this standard has been obscured by the inclusion of vertical services statistics.

Staff witness McClerren noted that there is a rulemaking proceeding underway to address Part 730, Standards of Service for Local Exchange Telecommunications Carriers. Among other things, Staff intends to review the definitions of measurements to ascertain that all parties are measuring performance in the same manner. In that proceeding, Staff claims it will recommend that vertical services should not be included in the installation calculation, and also to have additional lines treated as regular installations.

Staff suggests that, because it disagreed with the manner in which AI has defined Installation Within Five Days, AI should retroactively be found to have missed that benchmark during previous years. As a result, Staff argues ~~that~~ the Commission should reduce AI's rates by $29.5 million.

Second, Staff argues that $7.4 million should be flowed back to customers to correct for the improper re-classification of certain residential services as competitive, a classification which AI voluntarily withdrew in February of this year. ~~Staff also argues that approximately $74 million should be flowed back to customers to correct for the improper re-classification of certain business services as competitive~~

AI's Response

AI opposed ~~both~~ the refund proposals. With respect to Installation Within Five Days, AI contends that Staff's proposal is unreasonable because the Company has always reported its installation data including all new ("N"), transfer ("T") and change ("C") orders. Vertical service orders have generally been categorized as C orders. The Company pointed out that there is nothing inherently incorrect about this definition; in fact, it is the definition suggested by the language of a recent NARUC white paper on service quality measures. Even more importantly, AI argues that this is the way AI reported the data upon which the current Plan benchmark is based. Thus, had AI reported installation performance in the manner suggested by Staff, the benchmark would not be 95.44%. AI disputes ~~Staff's~~ Staff and City/GCI's suggestion that vertical service orders would have been negligible during the benchmark years of 1990-91 as not supported by the record. AI contends that the vast majority of its vertical services were introduced between 1974 and 1989, which suggests that vertical service orders were likely quite significant by 1990.

AI also argues that Staff's proposal would be unlawful. The Commission has reviewed and approved each of AI's annual rate filings under the Plan, including the service quality adjustments in the Plan's PCI calculations. AI contends that to impose a rate adjustment now, based upon Staff's current view of the manner in which installation data should have been (but were not) reported in the past, would be fraught with both legal and policy implications, including violation of the prohibition against retroactive ratemaking. Since AI's rates were previously lawfully approved by the Commission, AI argues that to require a refund now would be unlawful. Independent Voters of Illinois v. Commerce Commission, 117 Ill. 2d 90, 95-98 (1987).

AI also opposes a refund/credit associated with the reclassification of certain residential services and business services that ~~whichare were~~ the subject of Docket 98-0860. With respect to a credit for the residential services reclassification, AI states that Staff was not fully apprised of the relevant factual circumstances. After these services changed to competitive, AI explained that it made precisely the same reductions in their rates as it did in the rates of their noncompetitive counterparts. Therefore, AI claims there is no shortfall in the rate reductions that would otherwise have been required by the Plan. Moreover, AI contends these services have been incorporated in the Company's annual filing for calendar year 2000, which was submitted to the Commission on April 2, 2001~~(administrative notice requested)~~. AI argues that Staff's proposal would require the Company to reduce rates twice.

Commission Analysis and Conclusion

The Commission concludes that it will not adopt ~~either of~~the Staff's proposed one-time rate reduction or credit proposals. We agree with AI that it would be unreasonable to redefine or re-interpret the definition of the Installation Within 5 Days standard at this juncture and apply that definition retroactively to past reporting periods. The record demonstrates that AI has used its installation definition consistently since before the Plan was adopted and we therefore find no evidence of bad faith. Further as Staff points out, the Commission has already begun a rulemaking proceeding to address Part 730, Standards of Service for Local Exchange Telecommunications Carriers wherein Staff intends to review the definitions of measurements to ascertain that all parties are measuring performance in the same manner. In the rulemaking proceeding Staff may recommend that vertical services not be included in the installation calculation in the future.

~~With respect to the credit proposed~~ We reject the one time credit proposal made by Staff for AI's alleged premature reclassification of residential and business ~~services~~ . that services ~~issue is already properly before us in Docket 98-0860~~The legislature has spoken on this issue with the passage of HB 2900. With respect to Staff's proposal as to the $7.5 million which it suggests be "flowed back" to customers these services were incorporated into the Company's year 2000 annual filing and were approved by the Commission.

I. Improper Reclassification Penalties

GCI/City's Position

City/GCI propose a new penalty plan to discourage what it viewed as premature competitive classifications. City/GCI argues that, in order for the refund provisions to be invoked whenever appropriate, the Commission must investigate every improper reclassification, an undertaking which City/GCI claim is impractical given the broad range of services that AI has classified as competitive, and the lengthy and complicated proceedings required for an investigation. Additionally, City/GCI contend that AI has cited administrative problems associated with paying refunds, which have resulted in delays in refund payments.

City/GCI propose that the Commission adopt new safeguards against improper reclassification. First, City/GCI propose that on a going forward basis, the alternative regulation plan provide for financial consequences of up to $10,000.00 per day for competitive reclassifications that are later found to be improper by the Commission. City/GCI's proposed penalty would be in addition to any refund requirements applicable pursuant to the PUA. Second, City/GCI propose AI would be required to reclassify improperly classified services back to their noncompetitive status and reduce the rates of those services back to their pre-competitive reclassification level within five days of a Commission Order that rejects a competitive classification. Finally, City/GCI recommend that the Commission adopt an earnings sharing provision to reduce AI's incentive to prematurely reclassify services as competitive.

Staff's Position

Staff adopted the City/GCI proposal, arguing that incorporation of such a penalty would be sound, and in keeping with the purposes of the Plan. In Staff's view, such a penalty would discourage improper reclassification, and in turn would improve the effectiveness of the Plan. Moreover, in light of the fact that the Commission would, under the proposal, have considerable discretion to assess culpability for improper reclassifications, and reduce or remit any penalties based on such an assessment, the proposal should not be considered confiscatory or unreasonable.

AI's Response

AI opposes the improper reclassification penalty proposal. AI argues that reclassification penalties are unreasonable as a matter of regulatory policy. AI acknowledges that there has been an ongoing disagreement between itself, the Commission's Staff and City/GCI as to how much competition is required to support a reclassification under Section 13-502(b). Thus, AI contends that the fact that the parties have been at odds and the fact that prior re-classification dockets have proved to be lengthy and complex are not grounds for punishing AI. AI contends that it did not act illegally by declaring the services to be competitive in Docket 98-0860 and further